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TREASURY FOR OASIA - DOHNER/CUSHMAN/WINSHIP
TREASURY FOR AMBASSADOR HOLMER, DAN WRIGHT
STATE PASS FEDERAL RESERVE BOARD FOR JOHNSON/SCHINDLER; SAN FRANCISCO FRB FOR CURRAN; NEW YORK FRB FOR CLARK/CRYSTAL/DAWSON
STATE PASS CEA FOR BLOCK
STATE PASS USTR FOR STRATFORD/WINTER/MCCARTIN/KATZ
USDOC FOR ITA/MAC DAS KASOFF, MELCHER, MCQUEEN

E.O. 12958: N/A
TAGS: EFIN ECON PGOV SOCI CH
SUBJECT: AUTHORITIES IMPLEMENT MEASURES IN ATTEMPT TO BOOST CHINA'S STOCK MARKET

REF: A) Shanghai 28; B) 07 Shanghai 325; C) Shanghai 97

¶1. (SBU) Summary: TDY Econ Officer solicited views on China's equity markets, particularly in light of recent measures to boost market performance, which highlight authorities' continued efforts to manage the domestic equity markets. Two measures were implemented during the week of April 21, a reduction in the stamp tax on share trading and guidance on sales of non-tradable shares, which has pushed the Shanghai Composite Index (SCI) up 19% through the close of trading on April 30. These and other measures suggest authorities are increasingly concerned about the fall in the A-share market, which saw the Shanghai Composite Index decline 50% from its October 2007 peak (ref A). Questions remain about the authorities' ability to "manage the market" over the medium term, especially given negative retail investor sentiment and slowing corporate profit growth. End summary.

Have Authorities Drawn a Line in the Sand?

¶2. (SBU) In a widely anticipated move, Chinese authorities announced a reduction in the stamp tax from 0.3% to 0.1% after the market close on April 23 effective the following day. The announcement followed guidance issued on April 20 by the China Securities Regulatory Commission (CSRC), designed to alleviate concerns over a potential share supply overhang related to non-tradable shares (NTS), which are able to convert to tradable status beginning this year. The timing of the two measures suggests that policymakers are increasingly concerned about market stability, and may view both the 50% decline and the SCI 3,000 level as important thresholds.

¶3. (SBU) The decrease in the stamp duty is a reversal of last May's increase (ref B), enacted to stem what authorities viewed at the time as an already overheating market (the SCI quadrupled from May 2005 to May 2007). In the past, authorities have used policy and moral suasion to guide the market, but were generally content to let the market run-up continue leading up to last fall's National Party Congress. In the wake of the Party Congress, authorities attempted to manage the market down through window guidance and other measures. However, concerns have grown in recent months that the adjustment process has gotten away from them. Thus far in 2008, authorities have taken several steps to support the market, including approval of new domestic investment funds (in the past a successful way to boost the market), expanded quotas for foreign portfolio investment (QFII), suspension of corporate income taxes on mutual fund income and tighter regulation of new share issuance. Despite these measures, the market was down 41% year-to-date prior to the implementation of the most recent measures.

¶4. (SBU) Press reports and market speculation suggest that authorities may introduce additional measures soon. Most reports focus on the possibility of the launch of margin trading and the long-delayed stock market index futures (ref C) over the May Day holiday. Despite almost two years of mock trading and the issuance of futures licenses to brokers, final approval of index futures by the State Council has remained on hold given government concerns over short-selling in an already fragile market.

¶5. (SBU) Notably, these measures represent the first significant moves made by authorities since Wang Qishan was elevated to Vice Premier in charge of the financial portfolio at the National People's Congress in March. Vice Premier Wang's reputation for tough decision-making, including his refusal to support the troubled Guangdong International Trust and Investment Corporation (GITIC) as Vice Governor of Guangdong Province in 1998, had generated debate in the press over his willingness to "rescue the market." However, Shanghai-based financial sector analysts suggest that these recent measures may reinforce a perception among investors that the government will intervene to

support the market, particularly in advance of the Olympics in August and despite limited reported incidents of social unrest related to the market sell-off.

¶6. (SBU) In terms of the share supply overhang, the investment bank UBS estimates that up to RMB 1.5 trillion ($220 billion) in NTS will "unlock" (convert to tradable status) in 2008. Almost half the total conversion is set to occur in August (RMB 400 billion, $57 billion) and December (RMB 300 billion, $43 billion). The amount scheduled to "unlock" next year is even larger, with over RMB 600 billion ($86 billion) set to convert in September 2009 alone. The new NTS guidance states that holders of "unlocked" NTS seeking to sell 1% or more of a company's total shares within a one-month period must do so via privately negotiated block sales. In addition, controlling shareholders cannot transfer or sell unlocked NTS in the 30 days prior to the company's semi-annual or annual financial results. With these measures, authorities aim to reduce share price volatility, so that large block sales and sales by insiders during earnings reporting season will not impact open market trading. Although the size of the share overhang has clearly weighed negatively on market sentiment, one investment advisor in Shanghai argued that much of this fear is overblown since A-share listed companies' parent groups still control the majority of unlocked NTS and are reluctant to sell given that parent groups 1) do not have an immediate need to raise cash and 2) currently view their companies' share prices as undervalued.

Concerns Remain in the Market

¶7. (SBU) While the market jumped 9% on April 24, the largest one-day gain in over six years, following the cut in the stamp tax and is up 19% since April 18, it remains to be seen whether the authorities will succeed in halting the broader secular decline seen since October given slower retail investor demand and the prospects for slowing corporate earnings. Some market participants are skeptical. One Shanghai-based fund manager noted that all of the 36 new mutual funds approved by the CSRC since February have been small and retail investor interest has been tepid. Concerns are also growing around firms' ability to maintain profit growth, especially in an environment marked by tighter policy measures and rising input costs.

¶8. (SBU) This has led some analysts to highlight that valuations of A-share-listed companies remain rich at roughly 28 times earnings compared with H-shares (19 times). Among cross-listed companies, the average premium for A-shares relative to H-Shares stands at just under 40%, down from almost 50% in late March but still underscoring the relative valuation gap. However, A-shares for some large financial firms (Bank of Communications, Ping An Insurance, China Life Insurance) now trade at or below par with their cross-listed H-shares. As of the market close on April 30, H-shares have fallen 30% year-to-date compared to a 12% decline in the A-share index.

¶9. (SBU) Comment: If the market resumes its sell-off, Chinese willingness to promote domestic capital market reform could be adversely impacted. On the other hand, continued government intervention to support the market creates moral hazard and reinforces the view that the stock market remains a "policy market."
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